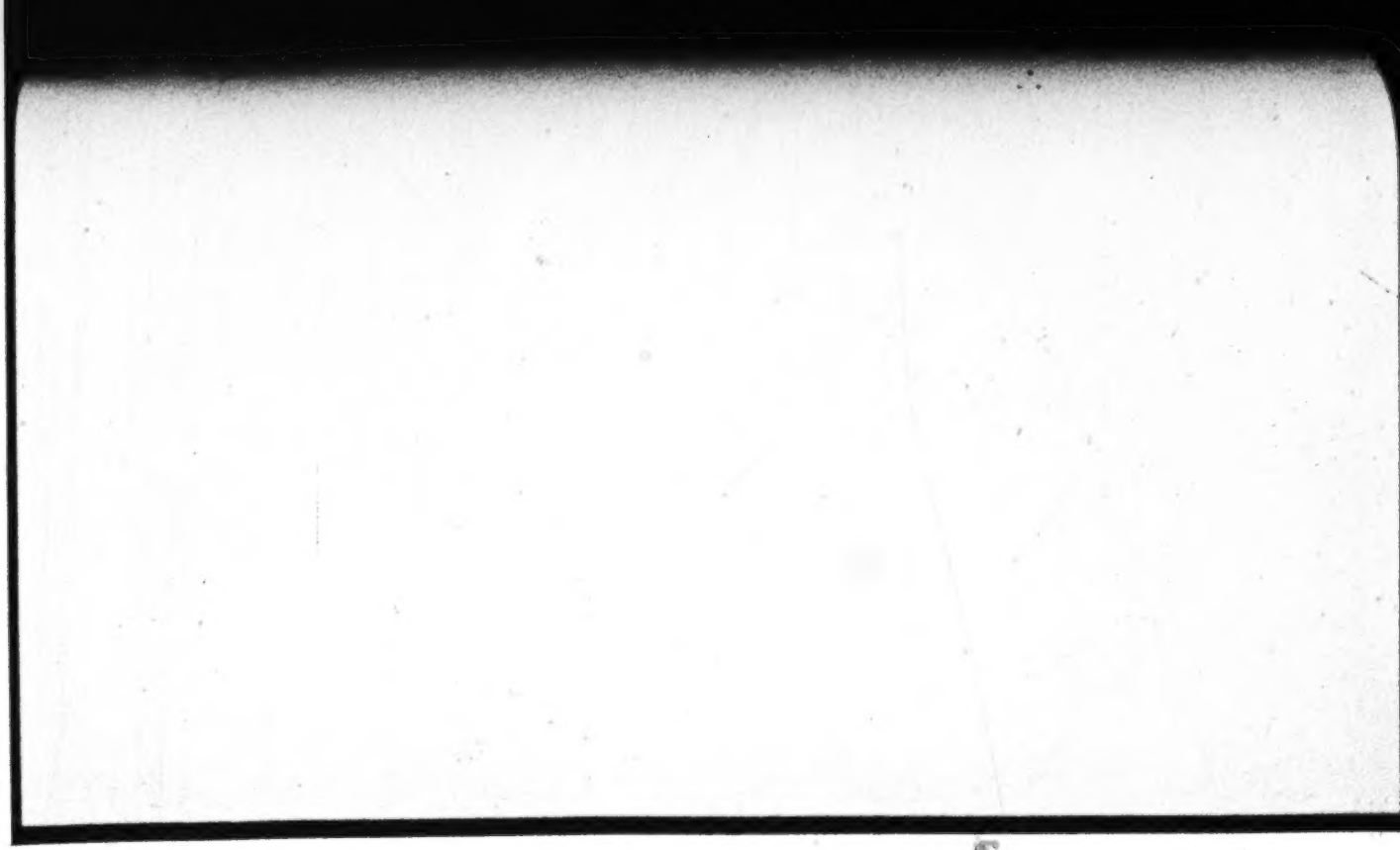

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1972

No. 72-488

TEXAS GAS TRANSMISSION CORPORATION, *Petitioner*

v.

MEMPHIS LIGHT, GAS AND WATER DIVISION, *et al.*

On Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

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REPLY BRIEF FOR PETITIONER, TEXAS GAS TRANSMISSION CORPORATION

While our main brief anticipates and deals with most of the arguments advanced by respondents,[1] a few matters have been raised which merit a reply.

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[1] There is a question as to whether American Public Gas Association (APGA) is a respondent in the cases before this Court. APGA's only intervention and participation in proceeding in the court below related to the Commission's Order No. 404 authorizing the change to normalization for new expansion properties. The court of appeals affirmed this Commission order and this Court has denied certiorari. *Memphis Light, Gas and Water Division* v. *F.P.C.*, No. 72-96, *cert. denied*, October 16, 1972. However, since APGA presents no arguments which have not been presented by other respondents, Texas Gas takes no position on this question.

I.

THE SPECIAL ELECTION IS MEANINGFUL—NOT REDUNDANT

In their efforts to support the holding of the Court below that Section 441 withdrew authority from the Commission to permit companies on flow-through to shift to other methods of tax depreciation, respondents would perpetuate that Court's error in failing to recognize that the third general rule[2] and the right of election are separate, distinct and without overlap. For example, the New York Commission claims that (Br. pp. 18-19):

> "* * * acceptance of the contentions that the election was separate and distinct from the other provisions of the section, which allegedly provided utilities like Texas Gas with a continuing power to switch from flow through to normalization with the consent of the Commission, would result in a situation in which the election as initially proposed by the Senate would be largely redundant and the Conference's later action in restricting its scope would constitute an exercise in futility." (See also APGA Br. p. 9)

In so urging, respondents completely disregard the showing made in our main brief (at pp. 24-26) that the election is wholly separate from, and does not overlap with, the third general rule. Thus, under the right of election as proposed by the Senate Committee and restricted by the Conference Committee, a company on

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[2] It is interesting to note that nowhere in the briefs of respondents are the first and second general rules even mentioned. As discussed in our main brief (at pp. 37-53) as well as in this reply brief, the first and second general rules are important and extremely helpful in ascertaining the Congressional intent particularly with respect to the "freeze."

flow-through is assured that it could shift from that method of tax depreciation with respect to the property covered by the election during the 180 day period *irrespective of the approval of its regulatory agency.*[3] To be sure, it would have to go to straight-line depreciation if the regulatory agency does not permit it to shift to normalization,—but regardless of the tax depreciation method preferred by the regulatory agency, the company had an absolute and unrestricted right to change from flow-through with respect to that property during the 180 days of the election period.

In contrast, under the third general rule, such a company has no assurance that it would ever be able to change from flow-through as to any of its property. That rule permits a company on flow-through to change to another method of tax depreciation—whether it be straight-line depreciation or normalization—*only with agency approval.* In other words, under the third rule, which is without time limit, the company does not have any right, let alone an absolute and unrestricted right, to change from flow-through. To the contrary, it is up to its regulatory agency, from time to time, to determine whether to permit the company to change to another method of tax depreciation. And if the agency does not give its permission, the company has no choice but to remain on its then current method.

We admit that, once the election has been made with respect to new expansion property, there is no remaining discretion in the regulatory agency to permit the use of anything but straight-line depreciation or liberalized depreciation with normalization as to such property. However, the third general rule is still ap-

[3] Emphasis supplied throughout unless otherwise noted.

plicable (1) to all property other than new expansion property for a company which exercises the election and (2) to *all* property for a company which does not exercise the election.[4]

These differences between the third rule and the election, coupled with the election's 180-day limited life and the indefinite life of the third general rule, make it perfectly clear that holding the election as proposed by the Senate and revised by the Conference Committee to be an addition to, rather than a replacement for, the third general rule does not render the election "largely redundant" or "an exercise in futility".

It should be further pointed out that we agree with the New York Commission (Br. p. 18) that it should not have been necessary for us to have analyzed the pertinent language of the Senate Committee Report in the detail we did. We believe that that Report, on its face, clearly discloses the intent of the Senate Committee that the third general rule was not to be affected or impaired in any way by its proposal also to provide a right of election. This, we believe, is indicated, for example, by the facts (1) that the Senate Committee Report treats the third general rule separately from the right of election, (2) that it expressly manifests its agreement with the House Committee as to the desirability of the third rule, and (3) that it refers to the right of election as an addition to the third rule by the inclusion of parenthetical phrase "except as provided in the committee amendments which are discussed below" in its summary of the third rule (See our main brief at pp. 17-26).

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[4] Under IRS regulations the election, once exercised, is irrevocable. IRS Regs. Sec. 1.167(1)-4(i).

II.

THE HOLDING OF COURT BELOW DOES NOT ACCORD WITH CONGRESSIONAL INTENT

Respondents urge that the holding below accords with the Congressional intent in enacting Section 441, claiming the Court's holding serves (1) to permit only limited general rate increases instead of "prompt, substantial and widespread rate increases" which Congress purportedly wished to avoid and (2) to implement the "freeze" on current depreciation practices which Congress allegedly was also intent upon imposing. See Memphis Br. pp. 9-15, 23; New York Comm. Br. pp. 23-29.

In so urging, respondents disregard a number of significant factors and considerations pointed out in detail in our main brief.[5] To begin with, the report of the House Committee which refers to a so-called "freeze" and a desire to avoid "prompt, substantial and widespread rate increases" (Texas Gas Br. App. pp. 78-79) also provides for the third general rule under which, as the Court below admitted "The Commission's and Texas Gas' position here [was] clearly justified" (FPC Pet. p. 32). In other words, there is nothing inconsistent between the Commission's retaining authority to permit companies to flow-through to change to other methods of tax depreciation and the objectives of the legislation as envisioned by the House Committee.

A. Congress Did Not Expect Only "Gradual" Rate Increases

As to rate increases, it should also be noted that it is only the House Committee report which refers to

[5] Since these matters are discussed in detail in our main brief (at pp. 36-62), we will summarize them here only briefly.

rate increases. Neither the Senate Committee nor the Conference Committee report makes any mention of rate increases. They refer to neither a desire to avoid "prompt, substantial and widespread increases" nor an intent to permit only limited *gradual* increases. Respondent's present argument, which is being made for the first time, that Congress intended only limited *gradual* rate increases is created out of whole cloth without any support whatsoever.

Further, while the House Committee mentioned an intent to avoid "prompt, substantial and widespread rate increases", it was in connection with the Committee's rejection of the FPC's suggestion that *all* regulated utilities be *required* to abandon liberalized depreciation, whether with normalization or with flow-through, and to change instead to straight-line depreciation. However, the House Committee could not have indicated an intent to limit rate increases only to those resulting from the *gradual shift* to normalization by the exercise of the right of election with respect to new property, as suggested by the New York Commission (Br. p. 28, fn. 13). The right of election was first included in proposed legislation upon the recommendation of the Senate Committee; the bill as recommended by the House Committee contained no such right of election. Thus, any rate increases contemplated by the House Committee, whether gradual or otherwise, could not have been limited to those resulting from the exercise of the right of election.

Moreover, as shown in our main brief (at pp. 51-52, 56-60), the House Committee recognized that the third rule would result in some rate increases. The House Committee estimated that its proposed amendment which, of course, did not include the election, would re-

sult in revenue increases of "$60 million in 1970, $260 million in 1974 and $310 million in 1979." In addition, the Committee clearly was aware, through the colloquy between Committee Chairman Mills and FPC Chairman White (see our main brief at p. 58) that there was a "very strong likelihood" that companies which shifted to a slower method of tax depreciation with respect to "assets acquired after a certain date" would come in for rate increases once they lost the "benefit of these tax reductions." The Senate Committee estimated the same revenue increases for its amendments other than the proposed election, to which it added that it was not possible to estimate the amount of the additional revenue increases which might result from "any possible election of those on flow-through to shift, within the 180 day period, to straight-line or normalization (if permitted by their regulatory agency)". See our main brief at p. 89.

Finally, the rate increases which would result from the Commission holding here are nowhere nearly as substantial or widespread as they would have been had Congress adopted the FPC recommendation *requiring all* regulated companies to go to straight-line depreciation. That recommendation would have made the change to straight-line *mandatory* for *all* regulated companies whereas here, the change to liberalized depreciation with normalization is *only* when found to be appropriate by the regulatory agency. Moreover, the Commission's action would not even result in rate increases for all the companies subject to its regulation (many pipeline companies and electric utilities did not exercise the right of election), much less would it result in rate increases for all the companies in the several industries covered by Section 441. This is par-

ticularly so since, as noted in the House Committee report (see our main brief at p. 82), many regulated companies prefer to remain on flow-through for a variety of reasons.

B. The "Freeze" Bars Only Shifts To Faster Methods—Not Shifts To Slower Methods

With further regard to the "freeze", it is to be noted *first* that Congress did not intend to provide an absolute "freeze". Both the House Report (at p. 133) and the Senate Report (at p. 172) provide only for a freeze "in general".

Second, the "freeze" is *intended to operate only one way* and *to apply only to changes to faster methods of tax depreciation.* Companies on straight-line depreciation may not change to any form of liberalized depreciation, normalization or flow-through. Companies on normalization may not change to flow-through. By imposing such a "freeze", Congress was assured that there would be no increase in the revenue losses already being incurred as a result of the increasing trend toward the use of faster depreciation methods fostered by the various regulatory agencies.

Third, the "freeze" is *not intended to prohibit changes to slower methods of tax depreciation.* Companies on straight-line depreciation may not change from that method since that is the slowest method. Companies on normalization may change to straight-line depreciation (but not to flow-through) and companies on flow-through may change to either straight-line or normalization. By permitting such changes to slower methods of tax depreciation *with agency permission,* Congress made it possible for companies to remain on flow-through where their situation made it desirable for them to do so while, at the same time,

leaving the way open for the revenue losses to be reduced in other situations where a change to a slower method of tax depreciation is appropriate. It was on the basis of such anticipated changes to slower methods of tax depreciation that the House and Senate Committees both made their estimates as to the tax revenue *increases* which they expected to result from the proposed legislation (see our main brief at 52-53).

Fourth, a "freeze" prohibiting changes generally from liberalized depreciation with flow-through would destroy the flexibility needed to accommodate to changing conditions. For example, when the so-called "cross-over point" is reached, all will admit that the public interest is better served by changing from liberalized depreciation to a straight-line method of tax depreciation. (See our main brief fn. 24, pp. 52-53.) In addition, it would frustrate the Congressional purposes by preventing the reduction in tax revenue losses which would come about when a company on flow-through changes to a slower method of tax depreciation and by perpetuating the very type of tax revenue losses which the Act's legislative history plainly discloses was obnoxious to many of the responsible members of Congress. (See our main brief at p. 53.)

III.

THE COMMISSION'S ACTION IN PERMITTING TEXAS GAS TO CHANGE TO NORMALIZATION FOR ITS EXISTING AND NEW NON-EXPANSION PROPERTIES WAS WELL WITHIN ITS DISCRETION

A. The Commission's Action Is Based Upon Expertise

Much of respondents' attack upon the Commission's conclusion on the merits permitting Texas Gas to change to normalization with respect to its pre-1970 and post-1969 non-expansion properties is addressed to the Commission finding that, in light of the changed cir-

cumstances since *Alabama-Tennessee,*[8] the continued use by Texas Gas of liberalized depreciation for these properties would no longer result in a *tax savings* justifying a continued requirement that it use flow-through.

Whether the use of liberalized depreciation results in a *tax savings* or *tax deferral* in the circumstances of a particular case is precisely the type of question which the courts have consistently treated as a matter within the Commission's special competency and expertise. See our main brief at pp. 63-65. For example, in *Alabama-Tennessee,* where the Commission had found, that in the circumstances then prevailing, the use of liberalized depreciation resulted in a tax savings, the Fifth Circuit declined to set aside that finding on the ground that it went to

> "* * * the competency of the Commission to choose between competing accounting theories and competing economic guesses. We see nothing irrational in the Commission's choice (359 F.2d at 339)."

Respondents' contentions here (Memphis Br., pp. 24-33; N.Y. Comm. Br., pp. 36-47; APGA Br., pp. 11-12) constitute in large measure a reiteration of the reasons why, in their view, the Commission should have adopted a different "economic theory and guess". Since our main brief (at pp. 65-75) shows there is nothing irrational in the "economic theory" which the Commission adopted in reaching its conclusion, it follows that the Commission's finding here, that use of liberalized depreciation for Texas Gas' old property would result in a tax deferral, should be affirmed.

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[8] *Alabama-Tennessee Natural Gas Co.,* 31 FPC 208 (1964) *affirmed sub nom. Alabama-Tennessee Natural Gas Co.* v. *F.P.C.,* 359 F. 2d 318 (5th Cir. 1966) *cert. denied,* 385 U.S. 847 (1966).

B. The So-Called "Actual Taxes Paid" Principle Does Not Prevent Use of Normalization

The foregoing conclusion in no way is affected by respondents' additional argument that permitting Texas Gas to change to normalization with respect to its pre-1970 and post-1969 non-expansion properties violates a so-called "actual taxes paid" principle which, respondents urge, imposes a duty upon the Commission to limit the income taxes allowed for ratemaking purposes to only the income taxes actually paid. See Memphis Br., pp. 4-5, 15-22; N.Y. Comm. Br., pp. 29-35; APGA Br., pp. 10-11.

This argument goes much too far. Taken literally, respondents' argument would render the use of normalization unlawful *per se*. The basic concept underlying normalization is that the income taxes allowed for rate making purposes are to be computed upon the basis of straight-line depreciation while the actual taxes to be paid are to be computed upon the basis of liberalized depreciation. This means that, under normalization the taxes allowed are greater than the taxes actually paid in the early years of a company's operations, and lower than the taxes actually paid in later years. If respondents' arguments were to be applied, as urged by them, it would be improper to permit normalization in those early years. Yet, it is clear that Congress and the courts have accepted normalization as a permissible method of determining the income tax to be allowed in a regulated company's cost of service.

The facts are, moreover, that the so-called "actual taxes paid" principle is not as sweeping as urged by respondents and that in actuality that "principle" has not been invoked as a reason for rejecting normaliza-

tion. To the contrary, the courts have repeatedly recognized that there is no inconsistency between normalization and this so-called principle. For example, the *El Paso* case,[7] relied on so heavily by both the New York Commission (Br. pp. 31-32; see also p. 44) and Memphis (Br. p. 18), involved not only "the treatment of special tax savings from depreciation and intangible drilling expenses, realized by the pipeline company from its production activities" as urged both by Memphis (Br. p. 18) and the New York Commission (Br. p. 31), but also the treatment of income taxes where the FPC had permitted the company to use normalization. The Fifth Circuit expressly approved this latter Commission action, stating (*Id.* at 573-4):

> "* * * Other than the depreciation item, whatever federal income taxes were actually paid for the test year should be treated as part of the cost of service regardless of whether these taxes were less than would have been paid but for the depletion allowance and the deduction for intangible drilling expense. No theoretical amount not actually paid can be so included.
>
> "The one exception, if it be an exception, is the treatment to be afforded the tax saving or deferral resulting from the use by the taxpayer of the declining balance method of depreciation of new equipment. In practical effect this works a tax deferral rather than a tax savings. * * * Therefore, we approve the Commission's treatment of the 'saving' resulting from using the declining balance method of depreciation for tax purposes but computing its taxes for rate making purposes on the straight line method of depreciation, placing

[7] *El Paso Natural Gas Co.* v. *F.P.C.*, 281 F.2d 567 (5th Cir. 1960, *cert. denied sub nom. California* v. *F.P.C.*, 366 U.S. 912 (1961).

such 'savings' in a special reserve to be used to equalize tax payments in later years. These amounts can never represent added return to the company because of the restriction as to their use."

See also, *City of Lexington* v. *F.P.C.*, 295 F. 2d 109 (4th Cir., 1961), where the Fourth Circuit similarly accepted such use of normalization as not inconsistent with the so-called "actual taxes paid" principle (*Id.* at 116-118). See also cases cited in our main brief at pp. 63-65.

Respondents seek to "soft pedal" this facet of the *El Paso* opinion. Memphis mentions it only by way of footnote (Br. p. 18, fn. 6) and the New York Commission (Br. pp. 33-35) discusses it, along with *City of Lexington,* only as part of a brief summary of the history of the Commission's treatment of the problem. However, the undisputable fact is that in both of these cases, the Commission permitted the company involved to use normalization and the courts' approval of that Commission action fully recognized that it was not inconsistent with so-called "actual taxes paid" principle.[8]

Memphis (Br. p. 18, fn. 6) would further belittle this facet of *El Paso* by characterizing it as attributable

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[8] In *City of Chicago* v. *F.P.C.*, 385 F.2d 629 (D.C. Cir. 1967), which Memphis cited as "again affirm[ing] the Commission's requirement of flow through" (Br. p. 19), the Court of Appeals expressly stated immediately following the excerpt quoted by Memphis (385 F.2d at 633):

> "However, as the Commission pointed out, in some cases normalization of tax deferrals is required lest future consumers be compelled to subsidize present consumers being served by the operations accruing tax liabilities."

to "the then current impression that the savings were only a deferral and that they represented an actual expense in the long run." However, all this proves is that the key question in dealing with the problem is the validity of the Commission's determination that liberalized depreciation results in a tax deferral. In other words, the governing criterion in reviewing the Commission's action relates to its finding that normalization resulted in a tax deferral—once that finding is held to be supported by substantial evidence, the "actual taxes paid" principle no longer stands in the way of permitting the company involved to use normalization. As Judge Leventhal phrased it in the *City of Chicago* case *supra* p. 637:

> "The Rule of Law does not forbid an agency from modifying its regulatory policy, and the courts have upheld policy revision many times.[26] Indeed one of the signal attributes of the administrative process is flexibility in reconsidering and reforming of policy. What is required by the Rule of Law is that agency policies and standards, whether or not modifications of previous policies, be reasonable and non-discriminatory, and flow rationally from findings that are reasonable inferences from substantial evidence."

[26] Citations omitted.

Since the Commission's finding here, that Texas Gas' use of liberalized depreciation for its pre-1970 and post-1969 non-expansion properties results in only a tax deferral, is "... reasonable and non-discriminatory, and flow[s] rationally from findings that are reasonable inferences from substantial evidence", it is well within its discretion and expertise (See our main brief at pp. 63-75). It, therefore, follows that the Commis-

sion's permission to Texas Gas to shift to normalization with respect to these properties does not violate the so-called "actual taxes paid" principle.

C. Funds Generated by the Use of Normalization for Expansion Properties Not Available To Offset Decline in Depreciation on Old Properties

Both Memphis (Br. pp. 24-30) and the New York Commission (Br. pp. 37-40) contend that Texas Gas does not require an increase in rates as a result of its election to discontinue the use of flow-through with respect to its new expansion property, because, the argument runs, with Texas Gas using liberalized depreciation for tax purposes on its new expansion property, the difference in taxes between the use of liberalized and straight-line depreciation on that property is available to offset the increased taxes on the old property.

This argument is completely specious. The entire concept of normalization is based upon the proposition that liberalized depreciation results in a tax deferral and that the difference is to be set aside in a reserve to be available in later years as the taxes increase. In the meantime, the funds are available to the taxpayer as an interest-free loan. To utilize that difference to offset the increased taxes on the old property will result in destroying the fundamental concept upon which normalization is based and, in effect, placing Texas Gas on flow-through with regard to its new expansion properties directly contrary to congressional intent in providing the election.

Moreover, under the Tax Reform Act of 1969, Congress, through the enactment of the special 180-day

election, has segregated property. Once the election has been exercised, the new expansion property must be considered separately from all other property. Thus, the use of normalization with respect to the new expansion property automatically earmarks the additional dollars and places them in a reserve for future higher taxes relating to that property. Consequently, they are not available to offset the higher tax expense resulting from the decline in depreciation with respect to the old properties.

Memphis and the New York Commission seek to answer the foregoing argument by further contending that there is no need to place these funds in a reserve, and that although the Commission's Uniform System of Accounts provides for such a reserve, the reserve is not so restricted and, in any case, there is no need for any such restriction. In so urging, respondents disregard the express provisions of Section 441 (a)(3)(G) of the Tax Reform Act of 1969. That section defines normalization, generally, as follows:

(i) the taxpayer must use the same method of depreciation (*i.e.*, straight line) to compute its tax expense and depreciation expense for ratemaking as well as book purposes. This is being done by Texas Gas.

(ii) if a different method is used for computing its actual taxes (*i.e.*, liberalized depreciation), then "... the taxpayer must *make adjustments to a reserve* to reflect the *deferral* of taxes resulting from the use of such different methods of depreciation." This is being done by Texas Gas.

Thus, respondents' argument that the funds generated through the normalization of new expansion property will be available to offset the increased taxes on the

old property is completely undercut by the clear language of the Tax Reform Act and flies in the teeth of the explicit Congressional recognition that an essential part of normalization is the creation of a reserve to be available for the future payment of presently deferred taxes.

Respondents' arguments are invalid for the further reason that since the Commission requires that the reserve for future taxes is to be deducted from a utility's rate base, the only way that a utility can continue to earn its allowed return is either (1) by adding to its rate base or utility plant, an amount at least equal to the additions in the reserve for future taxes or (2) by reducing its utility capital by a like amount through retirements, prepayments, or payment of dividends. Thus, it is apparent that the reserve dollars cannot be used for payment of higher taxes on old plant. Otherwise, the utility's return would be improperly reduced by that amount.

D. The Effective Date Used by the Commission Was Proper

Finally, Memphis argues (Br. pp. 32-33) that even if the Court finds against it on all other matters, the Commission nevertheless erred in permitting Texas Gas to change to normalization for its pre-1970 and post-1969 non-expansion property prior to January 1, 1971, because, according to Memphis, the election did not become effective as to the new expansion property until the first taxable year beginning after December 31, 1970. This claim is patently an after-thought, not having been raised in Memphis' application for rehearing; accordingly, consideration of this claim by the

Court is precluded under Section 19(b) of the Natural Gas Act.[9]

In any case, Memphis' claim has no merit. The Congressional purpose in thus postponing the effective date of the election was:

> "to provide sufficient time for the regulatory agency to authorize an electing company to change its books from flow-through to normalization and to use normalization in computing the rates charged to the company's customers, . . ." (S. Rep. No. 91-552 at p. 173, Texas Gas main brief App. 84)

In other words, the purpose of the postponement was to protect the regulated company from having to put the election into effect before it made the adjustments in rates required in order to avoid any resulting adverse financial impact. Since the election had to be exercised within 180 days of the enactment of the Tax Reform Act, many utilities could have been confronted —absent such postponement of the effective date of the election—with an immediate increase in revenue requirements associated with the change from flow-through to either normalization or straight-line depreciation for tax purposes without a corresponding increase in rates.

Here, the Commission's action had no such adverse impact upon Texas Gas. When Texas Gas exercised its right of election, it had a rate case pending before

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[9] Section 19(b) of the Natural Gas Act specifically provides that "[n]o objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission in the application for rehearing unless there is reasonable ground for failure so to do."

the Commission in which the proposed rates were at a level sufficient to accommodate normalization. Since, therefore, Texas Gas did not need any additional time to change its books and rates to reflect the use of normalization, the Commission's action herein was in accord with the congressional purposes.

CONCLUSION

For the foregoing reasons, as well as those set forth in our main brief, it is respectfully submitted that the judgment of the Court of Appeals should be reversed with directions to affirm the Commission's Opinions No. 578 and 578-A.

Respectfully submitted,

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